UNITED STATES DISTRICT COURT
SOUTHERN DISTRICT OF NEW YORK

DEBORAH DONOGHUE,

Plaintiff,

-against-

MIDWEST ENERGY EMISSIONS CORP.

Nominal Defendant,

-and-

ALTERNA CORE CAPITAL ASSETS FUND II, L.P., ALTERNA CAPITAL PARTNERS LLC, ALTERNA GENERAL PARTNER II LLC, AC MIDWEST ENERGY LLC, HARRY V. TOLL, ERIC M. PRESS, EARLE GOLDIN, JAMES C. FURNIVALL And ROGER P. MILLER,

Defendants,

15-cv-04611 (AJN)

MEMORANDUM OF LAW IN SUPPORT OF DEFENDANTS' MOTION TO DISMISS PLAINTIFF'S COMPLAINT

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Nominal defendant Midwest Energy Emissions Corp. ("Midwest") and defendants Alterna Core Capital Assets Fund II, L.P., Alterna Capital Partners LLC, Alterna General Partner II LLC, AC Midwest Energy LLC, Harry V. Toll, Eric M. Press, Earle Goldin, James C. Furnivall and Roger P. Miller (collectively, the "Alterna Defendants", and, together with Midwest, the "Defendants") respectfully submit this memorandum of law in support of their Motion to Dismiss Plaintiff's Complaint (the "Complaint" or "Compl.") pursuant to Federal Rule of Civil Procedure 12(b)(6).

PRELIMINARY STATEMENT

This motion addresses only one issue: whether the Alterna Defendants made a purchase of securities within the meaning of Section 16(b) of the Securities Exchange Act of 1934. As a matter of law, they could not and did not.

Under Section 16(b) "any profit realized by [a statutory insider] from any purchase and sale, or any sale and purchase, of any [covered] equity security … within any period of less than six months … shall inure to and be recoverable by the issuer." 15 U.S.C. §78p(b). Accordingly, "[t]o plead a plausible claim for a violation of Section 16(b), plaintiff must plead facts sufficient to show that there is the purchase and sale (or sale and purchase) of a security not otherwise exempt from Section 16(b) within six months by an insider, and that the insider realized a profit." *Donoghue v. Patterson*, 990 F.Supp.2d 421, 422 (S.D.N.Y. 2013). Section 16(b) expressly exempts "any transaction where [a] beneficial owner was not such at both the time of the purchase and sale, or the sale and purchase, of the security … involved …." 15 U.S.C. §78p(b). Further, where a transaction involves a contract that "is a derivative security then the relevant date of purchase or sale is that of execution, and not of exercise or settlement." *Patterson*, 990 F.Supp.2d at 426.

Here, Plaintiff has failed to allege and cannot allege that a "purchase" within the meaning of Section 16(b) occurred within six months of the alleged sale in March 2015[1]. This is true because the "purchase" of derivative securities that was accomplished as a result of the Alterna Defendants' entering into a financing agreement with Midwest occurred upon execution of the financing agreement in August 2014, prior to the Alterna Defendants' becoming beneficial owners subject to Section 16(b).

We respectfully submit that the Complaint be dismissed in its entirety.

STATEMENT OF FACTS

A. The Parties. Plaintiff Deborah Donoghue alleges that she is the owner of common stock of Midwest Energy Emissions Corp., a Delaware corporation. Declaration of Thomas M. Lancia, dated October 7, 2015 ("Lancia Decl."), Ex. A, Compl. ¶ 2. At certain times, the Alterna Defendants were subject to Section 16 of the Securities Exchange Act of 1934, as greater than ten percent beneficial owners of a class of Midwest's equity securities (but not as officers or directors of directors of Midwest). *Id* at ¶ 5.

B. The Allegations as Set Forth in the Complaint. Plaintiff in her complaint, setting forth all facts and claims upon information and belief, alleges that the Alterna Defendants violated Section 16(b) of the Securities Exchange Act of 1934 by purchasing warrants to acquire Midwest shares in open market transactions on four separate occasions: 107,139 warrant shares on December 31, 2014; 108,246 warrant shares on January 31, 2015; 98,781 warrant shares on February 28, 2015; and 81,164 warrant shares on May 31, 2015 at estimated fair market values of between \$0.36 and \$0.61. Compl. at ¶ 14. Plaintiff also alleges that, as a result of the repricing

[1] Defendants reserve all other defenses to the allegations in the Complaint, including, but not limited to, the allegation that the March 2015 transaction resulting in the re-pricing of a warrant is the equivalent of both a "sale" and a purchase. Compl. at ¶¶ 12, 13.

of a warrant on March 16, 2015, the Alterna Defendants are deemed to have sold the shares underlying the warrant at a fair market value of between $0.60 and $0.69. Compl. at ¶¶ 12, 13.

C. The Publicly Disclosed Facts Regarding the Relevant Transaction. "For purposes of a motion to dismiss [the Second Circuit has] deemed a complaint to include any … documents incorporated in it by reference … as well as public disclosure documents required by law to be, and that have been, filed with the SEC … and documents that the plaintiffs either possessed or knew about and upon which they relied in bringing the suit." *Rothman v. Gregor*, 220 F.3d 81, 88-89 (2d Cir. 2000) (citations omitted); *see also Kramer v. Time Warner, Inc.*, 937 F.2d 767, 774 (2d Cir. 1991); *Cortec Indus., Inc. v. Sum Holding, L.P.*, 949 F.2d 42, 47 (2d Cir. 1991).

Based upon the facts set forth in the Defendants' publicly available SEC filings, the Plaintiff's description of the transactions as set forth in the Complaint is inaccurate or incomplete in several material respects.

On August 14, 2014 Midwest and the Alterna Defendants entered into a series of agreements, including a financing agreement (the "Financing Agreement"), pursuant to the terms of which Midwest borrowed $10 million from the Alterna Defendants, as evidenced by a 12% senior secured convertible note (the "Note"), and in connection with which Midwest issued the Alterna Defendants a five year warrant (the "Warrant") to purchase shares of common stock (the "Financing Transaction"). Lancia Decl., Ex. B, Schedule 13D.

The relevant terms of the Financing Agreement provide that the Note bears interest at a rate of twelve percent per annum through maturity on July 31, 2018. For the first year interest accrues and is added to the unpaid principal balance of the Note, for the second year interest accrues at a rate of ten percent (and is added to the unpaid principal balance of the Note) and is payable in cash at a rate of two percent, and for the remaining term of the loan interest is payable entirely in cash. Interest accrues or is payable, as applicable, monthly, in arrears, on the last day of each calendar month. Lancia Decl., Ex. C, Financing Agreement, Section 2.2.

The Financing Agreement also provides that all or any portion of the principal balance of the Note may be converted into shares of Midwest common stock at a fixed price in accordance with a fixed formula, subject to certain specified adjustments. Lancia Decl., Ex. C, Financing Agreement, Section 2.2.

As a result of the Financing Transaction the Alterna Defendants became greater than ten percent beneficial owners Midwest's securities on August 14, 2014. Lancia Decl., Ex. B, Schedule 13D. Consistent with the obligations set forth in the Financing Agreement, on the last day of each calendar month, beginning on August 31, 2014 and continuing through August 31, 2016, the principal balance of the Note has and will continue to increase by an amount determined in accordance with the fixed interest formula. The Alterna Defendants' have never made open market purchases of warrants as alleged in the Complaint. Compl. at ¶ 14. The transactions at issue represent the accrual of interest pursuant to the terms of the Financing Agreement. On each of the alleged dates in question, interest on the loan accrued and was added to the unpaid principal balance of the Note in the following amounts: $107,139 on December 31, 2014, $108,246 on January 31, 2015, $98,781 on February 28, 2015, and $81,164 on May 31, 2015. Lancia Decl., Exs. D through G.

ARGUMENT

I. Legal Standard

To survive a motion to dismiss, a complaint must contain sufficient factual allegations to "state a claim to relief that is plausible on its face." *Ashcroft v. Iqbal*, 556 U.S. 662 (2009). While the Court must accept "well-pleaded factual allegations" as true, *Hayden v. Paterson*, 594 F.3d

150, 161 (2d Cir. 2010), "that tenet … is inapplicable to legal conclusions" and "[t]hreadbare recitals of the elements of a cause of action," *Iqbal*, 556 U.S. at 678; *Harris v. Mills*, 572 F.3d 66, 72 (2d Cir. 2009); *see, e.g.*, *Mercer v. Gupta*, 712 F.3d 756 (2d Cir. 2013).

II. Plaintiff's First Claim Fails to Allege a Matchable "Purchase" for Purposes of Section 16(b) Liability

Liability under Section 16(b) is dependent on a plaintiff proving that "there was (1) a purchase and (2) a sale of securities (3) by … a shareholder who owns more than ten percent of any one class of the issuer's securities, (4) within a six-month period." *Gwozdzinsky v. Zell/Chilmark Fund, L.P.*, 156 F.3d 305, 308 (2d Cir. 1998); *see also Patterson*, 990 F.Supp.2d at 422; *Donoghue v. Murdock*, No. 13 Civ. 1224, 2013 U.S. Dist. LEXIS 110605, at *8 (S.D.N.Y. Aug. 6. 2013). "Financial instruments that do not fall squarely into this framework are to be construed narrowly to favor the insider because of the strict-liability nature of Section 16(b). *Patterson*, 990 F.Supp.2d at 421 (citing *Levy v. Southbrook Int'l Invs., Ltd.*, 263 F.3d 10, 16 (2d Cir.2001)).

A. Liability Under Section 16(b) Only Attaches To Purchases and Sales of Securities That Occur After a Beneficial Owner Has Crossed the 10% Threshold

Section 16, and the rules promulgated by the SEC thereunder, govern beneficial ownership reporting and short-swing trading by statutory insiders (*i.e.*, directors, officers and greater than ten percent beneficial owners). Section 16(b) imposes liability to the extent of "any profit realized by [a statutory insider] from any purchase and sale, or any sale and purchase, of any [covered] equity security … within any period of less than six months …." 15 U.S.C. §78p(b). Certain securities and transactions are excluded from the provisions of Section 16(b), including "any transaction where [the] beneficial owner was not such at both the time of the purchase and sale, or the sale and purchase …." 15 U.S.C. §78p(b). Accordingly, the purchase that first places a beneficial owner over the ten percent threshold does not qualify as a purchase subject to Section 16(b) liability. *Foremost-McKensson, Inc. v. Provident Securities Co.*, 423 U.S. 232, 253-54 (1976) (codified in 17 C.F.R. §§240.16a-2(c) and 240.16a-10).

Here, prior to entering into the Financing Transaction in August 2014, the Alterna Defendants did not hold any Midwest securities. Thus, as a matter of law, the securities acquired in the Financing Transaction, as the "purchase" which first placed the Alterna Defendants over the ten percent beneficial ownership threshold, do not qualify as a "purchase" for purposes of Section 16(b) liability. On that basis alone, the complaint must be dismissed.

B. Under Section 16(b), A "Purchase" is Deemed to Have Occurred At the Execution of the Financing Agreement, Not Each Time Interest Accrues

In 1991 the SEC adopted a comprehensive regulatory framework addressing the application of Section 16 to derivative securities. SEC Release No. 34-28869, 56 Fed. Reg. 7242, 7248 (Feb. 21, 1991). That "framework recognizes that holding derivative securities is functionally equivalent to holding the underlying equity securities ..." and that "functional equivalence ... requires that the acquisition of the derivative security be deemed the significant event ..." for purposes of Section 16. *Id.* at 7248. The rational being that [j]ust as an insider's opportunity to profit commences when he purchases or sells the issuer's common stock, so too the opportunity to profit commences when the insider engages in transactions in ... derivative securities that provide an opportunity to obtain or dispose of the stock, at a fixed price. *Id.*

Derivative securities include "any option, warrant, convertible security, stock appreciation right, or similar right with an exercise or conversion privilege at a [fixed] price related to an equity security, or similar securities with a value derived from the value of an equity security ...." 17 C.F.R. §240.16a-1(c). The purchase of a derivative security for purposes of Section 16(b) occurs with "[t]he establishment of or increase in a call equivalent position ..." 17

C.F.R. §240.16b-6(a). A "call equivalent position" is "a derivative security position that increases in value as the value of the underlying equity increases, including, but not limited to, a long convertible security …." 17 C.F.R. §240.16a-1(b).

The Second Circuit and other courts have applied Section 16(b) and the rules promulgated by the SEC to a range of financial contracts that fall within the definition of derivative securities and have consistently held that regardless of whether "shares change[] hands on the [p]ayment [d]ate, rights to an equity security [are] still bought and sold at the time of contract." *Chechele v. Sperling*, 758 F.3d. 463, 468 (2d Cir. 2014) (finding the "sale" of securities underlying a prepaid variable forward contract occurred when the terms of the contract were established, not at settlement); *accord Donoghue v. Centillium Commc'ns Inc.*, No. 05 Civ. 4082, 2006 U.S. Dist. LEXIS 13221 (S.D.N.Y. Mar. 26, 2006); *see Morrison v. Madison Dearborn Capital Partners III, L.P.*, 389F.Supp.2d 596 (D. Del 2005) (holding the "purchase" of securities underlying convertible redeemable preferred stock with automatic adjustment provisions occurred when the preferred stock was acquired, not adjusted); *see also Patterson*, 990 F.Supp.2d 421; *Murdock*, 2013 U.S. Dist. LEXIS 110605, at *30-31.

The "common thread" among these cases "is that Section 16(b) is aimed at preventing insiders, during the six-month statutory window, from engaging in discretionary transactions that potentially could be based on inside information." *Murdock*, 2013 U.S. Dist. LEXIS at *15-16. When "obligations are fixed at the contract's execution … [an] insider cannot use insider information to affect the final settlement because he has no discretion after contract execution …" *Patterson*, 990 F.Supp.2d at 425-26. In other words, the window is closed on market manipulation and insider trading.

These holdings comport with Section 16(b)'s stated purpose of "preventing the unfair use of information which may have been obtained by [a] beneficial owner … by reason of his relationship to the issuer …" 15 U.S.C. §78p(b), by recognizing that there is no opportunity to manipulate insider information "after the contract is signed … [b]ecause the parties are bound to the formula and dates from the timing of the contract …." *Sperling*, 758 F.3d. at 470; *see Allaire Corp. v. Okumus*, 433 F.3d 248, 252 (2d Cir. 2006) (finding that "Section 16(b) covers only the transaction in which the parties agree to the terms … because that is the one in which the [beneficial owner] can be deemed to be using his or her inside information to arrive at the [] terms on a favorable basis."); *see also Murdock*, 2013 U.S. Dist. LEXIS 110605.

Here, the Note together with the terms set forth in the Financing Agreement constitute a derivative security (a "convertible security … with an exercise or conversion privilege at a [fixed] price related to an equity security") within meaning of Rule 16a-1(c). But the Alterna Defendants' rights and obligations with respect to interest accruing on the principal balance of the Note were established in the Financing Agreement when executed in August 2014, not the dates that interest accrued. Regardless of the date on which interest actually accrues to the principal balance of the Note, all of the obligations with respect to interest were determinable as of August 2014 and there is no discretion or opportunity for the manipulation of insider information after August 2014. Thus, in accordance with existing precedent in this Circuit, the only "purchase" to have occurred was in August 2014, more than seven months before the alleged "sale," rendering Plaintiff's claim deficient as a matter of law. As the Alterna Defendants were not greater than ten percent beneficial owners prior to acquiring Midwest securities in the Financing Transaction, as a matter of law, the "purchase" of the Note cannot qualify as a "purchase" for purposes of Section 16(b) liability. Accordingly, the Plaintiff's first claim is insufficient as it does not and cannot allege a matchable "purchase" for purposes of Section 16(b) liability. Accordingly, this claim must be dismissed.

III. Plaintiff's Second Claim Fails to Satisfy Even the Most Basic of Pleading Requirements

Plaintiff's second claim for relief alleges that as "a precaution against possible errors of detail attributable to inaccuracies in the public record or the discovery of additional trades ... [the Alterna Defendants] ... purchased and sold or sold and purchased equity securities or equity security equivalents of Midwest ... within less than six months of each other while insiders ... ." Compl. ¶¶ 17-18. Plaintiff fails to identity any basis for the foregoing allegation. Thus the allegation does not set forth "enough facts to state a claim to relief that is plausible on its face." *Bell Atl. Corp. v. Twombly*, 550 U.S. 544, 570 (2007).

At least two courts have dispensed with a substantially similar claim as failing to meet "the most basic pleading requirements of Rule 8 of the Federal Rules of Civil Procedure ...." *Chechele v. Morgan Stanley*, 896 F.Supp.2d 297, 305 (S.D.N.Y 2012) (citations omitted); *see Chechele v. Vicis Capital, LLC*, 2012 U.S. LEXIS 12107 (S.D.N.Y. Jan. 31, 2012). A claim asserted as a precaution against possible errors in the public record does not give "fair notice of the grounds upon which it rests and constitutes mere speculation." *Morgan Stanley*, 896 F.Supp.2d at 305.

Accordingly the Plaintiff's second claim fails to state a legally cognizable claim and should also be dismissed.

CONCLUSION

As a matter of law, the Defendants' "purchase" occurred in August 2014 prior to their becoming beneficial owners, thus rendering the transaction outside the scope of Section 16(b), the SEC's applicable rules and the relevant case law in the Second Circuit. Accordingly, the Defendants respectfully request that the Court dismiss the Complaint in its entirety.

Dated: October 7, 2015

Respectfully submitted,

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